

**DEPARTMENT OF STATE REVENUE
LETTER OF FINDINGS: 01-0319
Indiana Corporate Income Tax
For 1996 and 1997**

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ISSUES

I. Denominator of the Sales Factor – Adjusted Gross Income Tax.

Authority: IC 6-3-2-2(b); IC 6-3-2-2(b) to (n); IC 6-3-2-2(e); Sherwin-Williams Co. v. Indiana Dept. of State Revenue, 673 N.E.2d 849 (Ind. Tax Ct. 1996); 45 IAC 3.1-1-50(1); 45 IAC 3.1-1-50(5); 45 IAC 3.1-1-51; AT&T v Director, Division of Taxation, 476 A.2d 800 (N.J. Super. A.D. 1984).

Taxpayer argues that it correctly reported the denominator of its sale factor and that the Department of Revenue (Department) erred in reducing the denominator to reflect “sales everywhere” as reported on the taxpayer’s corresponding federal return.

II. Indiana Commodity Sales – Gross Income Tax.

Authority: IC 6-8.1-5-1(a); IC 6-8.1-5-1(b); 45 IAC 1.1-2-1.

Taxpayer maintains that – in the absence of specific sales records to the contrary – the audit review overestimated the amount of Indiana commodity sales by applying an inventory turnover ratio of six.

STATEMENT OF FACTS

Taxpayer is an out-of-state company in the chemical manufacturing business. It is also a licensed commodity broker buying and selling base and precious metals. In addition, it also provides services to its customers related to its brokerage business.

During 1996 and 1997, taxpayer maintained an inventory of commodities within Indiana. Taxpayer sold some of these commodities to Indiana customers.

During 2001, the Department of Revenue (Department) conducted an audit review of taxpayer’s state and federal tax returns. As a result of that audit review, the Department determined that taxpayer erred in reporting certain amounts of its income. The Department concluded that taxpayer owed additional Indiana corporate income tax. Taxpayer disagreed and submitted a

protest to that effect. An administrative hearing was conducted during which taxpayer explained the basis for its protest. This Letter of Findings results.

DISCUSSION

I. Denominator of the Sales Factor – Adjusted Gross Income Tax.

On its federal return for 1996, taxpayer reported 6 billion dollars in total sales. On its 1997 federal return, taxpayer reported 7 billion dollars in total sales.

However, on taxpayer's 1996 Indiana return, taxpayer reported 10 billion dollars in total sales. On taxpayer's 1997 Indiana return, taxpayer reported 11 billion dollars in total sales.

As might be expected, the audit review noticed this apparent discrepancy and adjusted the Indiana returns to mirror taxpayer's federal returns.

Taxpayer questions the audit's decision stating that it correctly reported its 1996 and 1997 total sales on the original Indiana returns. Taxpayer explains the discrepancy between the federal and Indiana numbers as follows. According to taxpayer – for purposes of reporting its federal income – taxpayer reported its income from trading precious metals on an "earnings basis." Specifically, it eliminated certain sales when it reported its 1996 and 1997 federal income. The sales that were eliminated were what it terms "non-industrial" sales of commodities. According to taxpayer's description, "non-industrial" sales occur when precious metal – such as gold – is sold for investment purposes. For example, taxpayer decides that it has an excess of gold on reserve and sells an amount of gold to another broker. In these "non-industrial" sales, the buyer does not obtain physical custody of the gold from taxpayer; taxpayer does not transfer physical custody of the gold to the buyer. Because of the high value of these precious metals and the security concerns related to storing or transporting the metals, the only thing which changes is the title to the gold.

The "non-industrial" sales are in contrast with the taxpayer's core business which is selling commodities to industrial customers. In those cases a buyer – such as a manufacturer of electronic components – purchases precious metal but takes physical possession of the metal because the metal is incorporated into the buyer's manufactured product.

In the case of "non-industrial" sales, taxpayer reports these amounts – for federal purposes – on a net basis because these particular sales "would have no impact on the computation of total income or taxable income for federal income tax purposes."

The issue is whether the gross amount of these "non-industrial" sales should have been included in determining in the denominator of the sales factor for the purpose of determining its Indiana adjusted gross income.

For purposes of calculating their adjusted gross income tax liability, corporations subject to the apportionment provisions of IC 6-3-2-2(b) to (n) are required to apportion their income according to a three-factor formula. "[I]f business income of a corporation or a nonresident

person is derived from sources within the state of Indiana and from sources without the state of Indiana, then the business income derived from sources within this state shall be determined by multiplying the business income derived from sources both within and without the state of Indiana by fraction, the numerator of which is the property factor plus the payroll factor, plus the sales factor, and denominator of which is three (3).” IC 6-3-2-2(b).

The portion of the three-factor calculation taxpayer now questions is the “sales factor” which is defined at IC 6-3-2-2(e) which states that, “The sales factor is a fraction, the numerator of which is the total sales of the taxpayer in this state during the taxable year, and the denominator of which is the total sales of the taxpayer everywhere during the taxable year.”

The term “sales” is defined in the Department’s regulation which states, “If the taxpayer’s business activity consists of manufacturing and selling and purchasing and reselling goods or products, ‘sales’ includes all gross receipts of such goods or products . . . held by the taxpayer for sale in the ordinary course of business.” 45 IAC 3.1-1-50(1).

Thereafter, the taxpayer’s sales income is reported in the “sales factor” as income received from sales attributable to Indiana or to sales everywhere. Taxpayer’s argument stems from the amount which should or should not be included in the denominator of the sales factor – the amount attributable to sales everywhere.

45 IAC 3.1-1-51 states in part that, “The denominator of the sales factor includes all gross receipts from the taxpayer’s sales”

Taxpayer concludes that the denominator should include the gross amount of its “non-industrial” sales of precious metals which were eliminated for purposes of reporting its income on the federal returns. The audit found that the gross amount of these “non-industrial” sales should not be included in the denominator on the ground that including the gross amount of sales would “unfairly represent the Indiana sales factor because the commodities are not traded in this state.”

The issue is whether the gross amount of these non-industrial sales should be included in the denominator of the sales factor or whether the net amount of sales should be included in the denominator of the sales factor. It is taxpayer’s contention that the gross amount should be included; it is the audit’s contention that the net amount should be included.

When taxpayer makes a “non-industrial” sale, it is essentially entering into a contract agreement to sell precious metals at a fixed price. Presumably, this “fixed price” is for an amount greater than what it originally paid for those same precious metals.

The Indiana Tax Court has addressed the specific issue raised by taxpayer and held, “‘Gross Receipts’ for the purpose of the sales factor includes *only* the interest income and not the rolled over capital or return of principal realized from the sale of investment securities.” Sherwin-Williams Co. v. Indiana Dept. of State Revenue, 673 N.E.2d 849, 853 (Ind. Tax Ct. 1996) (*Emphasis added*). The Court found that “[P]rincipal included in the proceeds of sale or redemption of short term-investments is not includible in the receipts factor.” *Id.* at 852. In arriving at that conclusion, the Tax Court cited to AT&T v Director, Division of Taxation, 476

A.2d 800, 802 (N.J. Super. A.D. 1984) which – in addressing the same issued raised by taxpayer – stated that “To include such receipts in the factor would be comparable to measuring business activity by the amount of money that a taxpayer repeatedly deposited and withdrew from its own bank account” and that to hold “otherwise produces an absurd interpretation of [the relevant statute].” Id.

Taxpayer is attempting to measure its business activity by the gross amount of money it obtains from buying and selling contracts for precious metals such as gold. The actual quantity of precious metals in these non-industrial contract sales remains the same; taxpayer generates profits (or losses) by buying and selling a fixed amount of precious metal. In effect, taxpayer is buying and selling the same fungible commodity and then measuring its business activity by the amount of gross sales. In measuring the amount of return on these contracts, taxpayer wants to have the best of both worlds; it wants to exclude the turnover on principal for federal income tax purposes, but it wants to include that same amount for purposes of measuring its Indiana sales activity. The taxpayer’s inconsistent proposal is inherently flawed and does not result in an accurate reflection of taxpayer’s Indiana income. The Department concludes that to allow the taxpayer to measure its business activity – the amount of its sales – in this manner would not accurately reflect taxpayer’s Indiana business activity and would not lead to an equitable apportionment of taxpayer’s Indiana income. Taxpayer may not include the return on principal realized each time it sells these precious metal contracts because including both the principal and profit would distort the sales factor by giving extra weight to out-of-state sales. As stated in 45 IAC 3.1-1-50(5), “In some cases, certain gross receipts should be disregarded in determining the sales factor to effectuate an equitable apportionment.”

FINDING

Taxpayer’s protest is respectfully denied.

II. Indiana Commodity Sales – Gross Income Tax.

During 1996 and 1997, taxpayer maintained an inventory of commodities within Indiana. The audit confirmed that sales from this Indiana location were made to customers within Indiana. However, the taxpayer could not provide details of these Indiana sales. Finding that the money received from these sales was subject to Indiana gross income tax pursuant to 45 IAC 1.1-2-1, the audit prepared an estimate of the Indiana sales and assessed tax accordingly. The audit estimated the receipts by applying an inventory turnover ratio of 6 along with an estimated gross profit. The taxpayer challenged the methodology arguing that the turnover ratio of 6 “may not accurately reflect the proper taxable receipts related to the Indiana inventory.” As an alternative, taxpayer proposes that an inventory turnover ratio of two be employed to more accurately reflect the taxpayer’s gross income tax liability.

The Department is authorized to prepare an assessment of taxes in situations where the taxpayer has underestimated its tax liability. IC 6-8.1-5-1(a) states that, “If the department reasonably believes that a person has not reported the proper amount of tax due, the department shall make a proposed assessment of the amount of the unpaid tax on the basis of the best information available to the department.” There is no question that taxpayer failed to report “the proper

amount of tax due” because, despite the fact that it was selling commodities to Indiana customers from an Indiana location, it failed to report any of these sales for gross income tax purposes. Therefore, the audit was entirely justified in preparing a sales receipts estimate based upon the best information available.

Having prepared that estimate, it is taxpayer’s responsibility to refute the estimated conclusion if it believes that the audit erred in its conclusion. “The notice of proposed assessment is prima facie evidence that the department’s claim for the unpaid tax is valid. The burden of proving that the proposed assessment is wrong rests with the person against whom the proposed is made.” IC 6-8.1-5-1(b). Other than making an off-hand suggestion that it would prefer the Department employ an inventory ratio of 2, taxpayer has failed to meet its burden of demonstrating that the proposed assessment of gross income tax is erroneous. Taxpayer failed to provide the requested Indiana sales information at the time the audit report was prepared. In its initial protest of the assessment, taxpayer provided no information which would serve as a basis for challenging the assessment. Despite a specific request to do so, taxpayer failed to provide the detailed sales information following the hearing which would substantiate the basis for its challenge to the gross income tax assessment.

FINDING

Taxpayer’s protest is respectfully denied.